KAPSTREAM
CAPITAL

Central bankers take your mark… get set… GO!

The Beijing Olympics have been over for months, however the monetary policy foot race is just beginning. As the world heads into year end, Central bankers are embarking on some of the most aggressive rate cutting ever seen. Triple digit rate cuts seem to be the norm these days, evident by the first week of December, where five major central banks slashed rates a combined 600 basis points. This includes the RBA, which has effectively reversed six years worth of tightening in just three months.

The good news is that governments worldwide are alert to the risks inherent to the global economy and are sprinting to the finish line. We are also seeing some fiscal policy easing with the hopes that people will start spending. However, consumer spending is declining at a record pace (an unprecedented four months in a row), while the savings rate has jumped to 2.4% from 1.0%, a sign of heightened risk aversion and capital preservation, and a shift that many believe to be secular, not merely cyclical.

This has led to Fed to start quantitative easing, a monetary policy tool used to inject liquidity (via the purchase of bonds), promote lending and lower the long end of the curve. As Chairman Bernanke has stated that, 'although further reductions from the current federal funds rate target of one percent are certainly feasible, at this point the scope for using conventional interest rate policies to support the economy is obviously limited.' However, as Stephen Stanley from RBS has suggested, the Fed can buy treasuries until they are blue in the face, but that will only have a limited effect on thawing out the credit markets. In contrast, injecting large sums of money into system (i.e. new mortgage plan, equity stakes in banks to generate lending, etc) can have a much bigger impact. This is a necessary component to resolve the crisis. Cutting rates have done little to halt house price declines. Nor will they make poorly run companies viable again.

Focusing on Australia, the market expects cash rates to hit 3.25% by early to mid next year. This would be the lowest cash rate in Australia since the 1960s, and considered aggressive in the historical context. But it would it would still leave the RBA cash rate much higher than the average cash rate for nearly all developed economies. According to JP Morgan, while there have been noticeable signs of cracking, there is little doubt that the Australian economy looks, at least in a relative sense, in better shape than a number of its offshore counterparts. Yet if the global marketplace continues to deteriorate, the RBA may be forced to lower rates to levels Aussies haven't seen for over 50 years. So long as unemployment in Australia continues to move higher while inflation is trending lower, the RBA will be under pressure to cut further.

Kapstream identifies some key themes as we head into 2009:

- Rates will be low for a long time: In the US, the Fed is typically on hold for a minimum of 12-18 months following their last cut. Ifthat average holds, we will not see rate hikes until 2010. The RBA will act in a similar fashion. As Rory Robertson of Macquarie recently stated, monetary policy tightening will not start 'until unemployment starts falling, probably at least a couple years down the track.'
- Analysts predict that US 10 year rates will hit 2% (roughly 50 basis points from current levels). Similarly in Australia, rates have fallen so quickly, that the bulk of the rally has passed. Investors should shift their focus away from duration and into high quality credit names globally.

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- Retailers will limp through the Christmas season. As unemployment continues to rise, less people will spend, squeezing corporation's profits.
- Oil will continue to fall, as the deepening recession in the U.S., Europe and Japan cuts fuel consumption. The threats of an oil shock and $140/barrel seem like a distant memory.
- The US auto industry will get bailed out, yet it will be under very strict guidelines to re-structure the unions and pension schemes.
- Corporations (especially banks) will continue issue government guaranteed debt via Fed acting as the new monoline insurer. These bonds are trading at a discount to US government bonds and a premium to the unguaranteed senior debt. This will allow them to fund themselves at cheaper levels and hopefully help in adding some much needed liquidity to the credit markets.

2008 has been a year that most investors will be only too keen to put behind them. As we enter a global recession, the economic prospects for 2009 certainly do not make us feel overly optimistic but they will also provide participants with good opportunities to purchase undervalued assets.

On behalf of Kapstream, we wish everyone a very Merry Christmas and a prosperous New Year.